

Commercial Banking and Democracy: The Illusive Quest for Deregulation

Jonathan R. Macey[†]

Government regulation is often necessary, sometimes in heavy doses, for private markets to function effectively. This Article presents three case studies from the banking industry to support this thesis. The first case study, the deregulation of Savings and Loans in the early 1980s, is a good example of how deregulation can produce disastrous results and market failures. The second case study examines an EPA regulation which allows banks to avoid liability when demanding that borrowers comply with environmental laws—a socially optimal result. The third study considers the regulation of deposit insurance. Deposit insurance and its regulation prevents bank runs and panics, inherent problems of depository institutions. In the United States, the most effective regulation of deposit insurance comes at the federal level. It is a system that heavily regulates insured banks. The Federal Deposit Insurance Corporation requires member banks to maintain a minimum level of reserves, regulates bank closure, and sets minimum capital requirements. Deposit insurance represents beneficial government regulation. Taken together, these banking regulation case studies are prime examples of how government regulation is sometimes necessary for effective markets.

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[†] Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law, Yale Law School. I am grateful for helpful comments and suggestions from Ian Ayres, Richard Carnell, Jacob Hacker, Henry Hansmann, Marc K. Laundry, Martin A. Levin, Maureen O'Hara, Peter Schuck, Martin Shapiro, and Alan Schwartz, as well as the participants in "The Politics and the Economics of the Market" Seminar at Brandeis University and the Faculty Workshop at Yale Law School. Mark Cho, Yale Law School Class of 2006, provided invaluable research assistance.

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Introduction

People of all political stripes tend to think of regulatory policy as involving straightforward choices between regulation and deregulation. Those most concerned with market failure and equality of outcomes generally favor regulation and those with faith in markets and concerns about efficient outcomes generally prefer deregulation.

The point of this paper is to demonstrate that government regulation is necessary, sometimes in heavy doses, for private markets to function well. This Article illustrates this thesis, which can be summarized succinctly as arguing that the government should foster markets (“mercerize”), by employing several case studies from the banking industry. These studies reveal that free markets may need government regulation to provide the benefits that free market capitalism’s proponents promise. In other words, it often is the case that “freer markets need more rules.”

Deregulation is touted as a panacea not only for problems created by failures of the regulatory state, but also for problems created by the politicization of the bureaucratic process.¹ But deregulation is not a cure-all for either problem. In the particular case of banking, what has passed for “deregulation” cannot accurately be described as such, because it neither removes the government from the regulatory sphere nor even reduces its influence in a meaningful way. Consequently, deregulation is unlikely to produce better policies in most cases. In fact, deregulation often generates disastrous policy results.²

Sometimes what is called regulation imposes more costs on business and taxpayers; other times, it actually creates socially optimal incentives for private actors to order their behavior on their own in ways that benefit not only themselves, but also others.

Moreover, the policy choices to regulate, to deregulate, and to continue regulation all have the political attributes typically associated with regulation.

¹ The term deregulation describes the act of freeing people and firms from the effects of regulation, particularly government regulation. Here I argue that government action that is cloaked in the guise of being deregulatory often is, in fact, anti-competitive. The reason for this is that statutes and other acts of ostensible deregulation are almost inevitably incomplete. They eliminate part, but not all, of an extant regulatory scheme. The crucial fact that deregulation almost never accomplishes complete government withdrawal from a particular sphere of activity has been under-analyzed in the law-and-economics and regulation literatures.

² For example, the Savings and Loan (“S&L”) collapse of the late 1980s came about after many S&Ls, after a long period of deregulation, began making riskier loans and offering higher interest rates on their deposit accounts. *See* discussion *infra* Part II; *see also* MARTIN LOWY, HIGH ROLLERS: INSIDE THE SAVINGS AND LOAN DEBACLE 246-48 (1991); LAWRENCE J. WHITE, THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION 74-75 (1991).

Namely, these various policy choices are all informed by vigorous lobbying and other forms of rent-seeking. As a consequence, the process by which these policy decisions were reached can tell us a great deal about the likely effects of such choices, both in terms of efficiency and in terms of wealth distribution.³

The general thesis of this Article—that regulatory intervention beyond mere contract enforcement often is needed to protect markets—is a broad one. The evidence in support of the thesis presented here consists of a variety of case studies from the banking industry; together they demonstrate that regulation is often necessary for markets to function effectively. The banking industry, chosen for illustrative purposes in this Article, provides an extreme example of the general phenomenon described here. The example is “extreme” because, as discussed below, the political salience of bank failures makes it difficult for regulators and politicians to avoid bailing out the depositors and other creditors of failed banks. The situation described here can be generalized to any public policy context in which politicians and regulators are induced by competitive pressures to respond to a crisis. Where government is free of political pressures to accept responsibility for the consequences of market forces, including market corrections and the bursting of bubbles, then regulation may not be necessary in order to protect the operation of markets. But whenever government actors have political incentives to respond to unforeseen events that roil markets, regulation is necessary to protect markets from the political responses to these events. Thus, while the points made here cannot be generalized to every context in which markets operate, they are clearly applicable beyond the context of the financial services industry which is the particular focus of this Article.⁴

Turning to the specific case of banking, the economic and political significance of deposit insurance must be understood. Deposit insurance is part

3 See Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 268 (1986); see also JAMES M. BUCHANAN & GORDON TULLOCK, *CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* (1966); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

4 For example, the political and regulatory fallout that followed recent devastation caused by Hurricane Katrina illustrates that regulation is necessary to supplement private ordering in the context of the government's response to natural disasters in exactly the same way that regulation is necessary in the context of banking. It is difficult to specify precisely the circumstances under which government intervention is necessary for incumbents' political survival. This is an important area for future research in the field of regulation. A very important avenue of inquiry is the extent to which government programs create dependency. This Article makes the point that deposit insurance (a policy innovation strongly supported by economic analysis) created a demand for a host of other governmental programs, particularly those directed at promoting the safety and soundness of depository institutions insured by the government-sponsored deposit insurance scheme. Similarly, it was argued that the Health Security Act proposed by a government task force headed by Hillary Clinton would create dependency on government and bring with it new demand for federal bureaucracy. See Dick Arney & Newt Gingrich, *The Welfarization of Health Care*, NAT'L REV., Feb. 7, 1994, at 53, 56; Richard E. Ralston, *Clinton Versus Your Health*, AYN RAND INST., July 28, 1998, http://www.aynrand.org/site/News2?JServSessionIdr011=zyv7ty1jsl.app14b&page=NewsArticle&id=5261&news_iv_ctrl=1021.

of the fabric of democracy: Politicians in a political marketplace characterized by rivalrous competition take ownership of bank failures and must respond to such failures, either *ex ante* (before the failure) or *ex post* (after the failure), by providing assurances to depositors that they will be paid. Thus, I will argue that in democracies either explicit *de jure* deposit insurance (government guarantees prior to any banking crisis) or implicit *de facto* deposit insurance (government bailout following a banking crisis in the absence of prior guarantees) must be taken into account when evaluating the merits of any proposed efforts to achieve deregulation.

Part I begins by providing some background about the nature of the business of banking and explains the theoretical underpinnings of the thesis. The remainder of the Article then examines actual examples of banking regulation and deregulation. Part II explores banking deregulation and the Savings and Loan (“S&L”) crisis of the early 1980s. The rapid deregulation of the S&Ls during that period led to excessive risk-taking and their ultimate demise. Part III examines bank regulation which originated from the Environmental Protection Agency. The EPA regulation protects lenders that demand that certain borrowers comply with environmental laws. Before the regulation, banks that demanded environmental compliance from a borrower could be liable for the same borrower’s violations. Such banking regulation promotes efficient lending and socially desirable activity—monitoring of hazardous waste—by eliminating the potential liability of banks who lend to borrowers dealing with hazardous materials.

Part IV examines state-federal relations to demonstrate that state regulation is often sub-optimal because states are subject to a variety of moral hazard problems that weaken their incentives to regulate effectively. In particular, when states regulate banks, they have incentives to create rules that promote excessive risk-taking, because the states disproportionately benefit when banks are successful. When banks fail, however, states share losses with other states through the federal system of deposit insurance. This Article concludes that regulation can foster markets, and that deregulation may only succeed when coupled with a strong guiding hand from government.

I. Banking: Economic and Political Theory

A. *Core Characteristics of Banking*

Three core structural features distinguish banks⁵ from other sorts of businesses in the economy. First, banks are systematically far more highly leveraged than other kinds of firms in the economy. On average, well-

5 Following long-standing custom, while financial intermediaries come in many forms, the subset of financial intermediaries known as “banks” are those that combine commercial lending with transaction services, particularly demand deposits. See generally JONATHAN R. MACEY ET AL., *BANKING LAW AND REGULATION* 47-56 (3d ed. 2001).

capitalized banks have debt-equity ratios of 10:1, as opposed to the 1:1 debt-equity ratios typical of non-financial firms.⁶

Second, banks' balance sheets are characterized by severe disparities in the liquidity and transparency of assets and liabilities. Banks' assets (commercial and home mortgage loans) tend to be highly illiquid and opaque, while their liabilities tend to be highly liquid and transparent (transaction accounts—particularly checking accounts and short- and medium-term certificates of deposit).⁷

Finally, banks' balance sheets are unusual because of the mismatch in the term-structures of their assets and liabilities.⁸ Bank assets tend to be invested in long-term instruments (loans to commercial and residential borrowers), while their liabilities take the form of deposits, most of which are available on demand (checking accounts) or in the extremely short-term (federal funds and short-term certificates of deposit). While the precise relationships change over time, it is not unusual for the average maturity of banks' liabilities to be only six months, while the average maturity of banks' assets is six years.

These core characteristics of banks are endogenous. Specifically, these characteristics pre-date exogenous regulatory events such as the introduction of government-issued currency to replace bank-issued specie, and, of course, the more recent introduction of deposit insurance. These defining characteristics of banks follow from the existence of economies of scope that are generated when lending and deposit-taking are combined. Lending requires close monitoring of borrowers, and deposit-taking facilitates such monitoring by giving bankers accurate, real-time information about borrowers' cash flows. Moreover, banks' ability to profit, deriving from the spread between what banks pay to attract deposits and other liabilities and what banks earn on their loans and other assets, is closely linked to these three central characteristics.

B. *Bank Runs and Panics*

The core characteristics of banks that I have just described make banks susceptible to runs and panics. Banks are inherently unstable because depositors have access to banks' liquidity on a first-come, first-served basis. This means that if depositors experience an unexpectedly large demand for liquidity, banks will encounter a run as word of the liquidity demand spreads and depositors attempt to protect themselves by cashing in their accounts.

In other words, bank depositors face a prisoner's dilemma. The best strategy for depositors as a group is to refrain from withdrawing their funds precipitously and to base withdrawal decisions not on what other depositors do, but on their own endogenous need for liquidity over their life cycles. By

6 *Id.* at 67.

7 *Id.* at 68.

8 *Id.*

contrast, the safest strategy for depositors as individuals is to withdraw their funds the moment they hear the slightest rumor of financial weakness within the bank, or even unusual activity among depositors. This strategy wins because no bank can meet the liquidity needs of all of its depositors at once in light of its high leverage, low liquidity, and mismatch in the term-structure of assets and liabilities. Banks, in the absence of a credible deposit insurance regime, are extremely unstable creatures. That is why even the most free-market observers, such as Milton Friedman and Catherine England, favor federally sponsored deposit insurance plans, at least as an option for banks and depositors.⁹

The notable lack of success of private (and even state-based¹⁰) deposit insurance funds due to lack of credibility and transparency, coupled with the overall economic importance of banks in allocating capital and serving as repositories for savings, creates a demand for regulation. Banks are critical to markets; however, to create a market for banks, government provision of deposit insurance is needed.

In turn, government-sponsored deposit insurance schemes create a demand for massive government regulation, because once the government enters the business of offering deposit insurance, it must take steps to limit its liability and to curb the inevitable moral hazard: bankers will try to transfer wealth from the government's insurance fund to themselves by increasing the riskiness of their activities once the deposit insurance scheme is in place.

C. *Deposit Insurance and Government Regulation*

Milton Friedman argued that government regulation of some kind was necessary to prevent bank failure.¹¹ Regulation could take the form of deposit insurance, which operates *ex ante* to prevent bank runs and panics, or it could operate *ex post* by using monetary policy orchestrated by the central bank to

9 See Catherine England, *Private Deposit Insurance: Stabilizing the Banking System*, CATO INST., June 21, 1985, <http://www.cato.org/pubs/pas/pa054.html> (proposing that every bank be able to "choose among several federal deposit insurance plans" from insurance on 100% of its deposits, thereby "extending explicit protection even beyond that available today" to permitting banks to choose to provide no federal insurance to its depositors in exchange for "no federal regulation of its activities"). See generally MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES* (1963).

10 Maryland and Ohio were among the last states to have state-administered deposit insurance schemes. Both of these schemes collapsed ignominiously during the spring of 1985, and were the death knell of state deposit insurance funds. See J. Huston McCulloch, *The Ohio S&L Crisis in Retrospect: Implications for the Current Federal Deposit Insurance Crisis*, in FED. RESERVE BANK OF CHI., *MERGING COMMERCIAL AND INVESTMENT BANKING: PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION* 230-51 (1987); Steven Pressman, *Behind the S&L Crisis*, 2 EDITORIAL RES. REP. 550 (1988); Walker F. Todd, *Similarities and Dissimilarities in the Collapses of Three State-Chartered Private Deposit Insurance Funds* (Fed. Reserve Bank of Cleveland, Working Paper No. 9411, 1994); Federal Deposit Insurance Corporation, *The S&L Crisis: A Chrono-Bibliography*, <http://www.fdic.gov/bank/historical/s&l/> (last visited Oct. 18, 2005).

11 See FRIEDMAN & SCHWARTZ, *supra* note 9, at 434.

inject money into the system and provide liquidity for banks that were the subject of runs and panics. In *A Monetary History of the United States*, Friedman and Schwartz observed that the Federal Reserve failed to do its job during the banking crisis that followed the stock market collapse in 1929. They argued that the Fed had permitted a collapse of the monetary system by permitting perfectly sound banks to fail by the thousands because of liquidity problems, despite the fact that the Fed had been set up in 1913 with the objective of preventing precisely that occurrence. Friedman and Schwartz argued that, because the Fed had failed in its responsibilities and showed no sign of improving, "something else was needed to perform the function for which it had originally been established and . . . the Federal Deposit Insurance Corporation would serve that function."¹²

As Professor Friedman has pointed out, deposit insurance worked extremely well for over forty years in accomplishing its stated purpose of preventing bank failures. As he has observed, from 1934 until the early 1970s, there were very few bank failures and essentially no runs on banks due to liquidity problems.¹³

Market-oriented economists see deposit insurance, and hence government regulation, as necessary simply to permit banks to operate in the market without causing major macroeconomic dislocation. In addition, there is an independent reason, based on real-world political considerations, why government-sponsored deposit insurance is critical to a well-functioning economy. This analysis is based on the straightforward assumption that banks, like all other firms and individuals in the economy, operate in a world in which there is government.

Where there is government, even where there is no governmental regulation, there is always the potential for governmental regulation. As such, it is critical for policymakers and analysts to recognize that the level of governmental regulation at Time 1 affects the government's predicted response to an event at Time 2. Namely, where banks operate in democracies, political actors are subject to electoral pressures. Thus, irrespective of one's *philosophical* preference for a libertarian state, incumbent need for political support will determine the level of *actual* regulation. Deregulation, regardless of its theoretical merits, may not be a viable survival strategy for political actors.

This argument has profound implications for the regulation-deregulation debate. Those who favor deregulation must find an implementation strategy consistent with political actors' desire for survival. Otherwise, the press for deregulation (or regulation) in the face of widespread, well-organized political opposition can never succeed because those who support such unpopular views

¹² David Levy, *Interview with Milton Friedman*, THE REGION, June 1992, <http://minneapolisfed.org/pubs/region/92-06/int926.cfm>.

¹³ See FRIEDMAN & SCHWARTZ, *supra* note 9, at 434-42.

will be replaced by entrepreneurial, opportunistic politicians who oppose them. The take-away lesson is that once one admits the inevitability of certain governmental action, such as providing deposit insurance, or taxing corporate profits, or providing police protection for citizens, we must similarly acknowledge the necessity of governmental regulation. Thus, the question is not whether to regulate at all, but how to regulate most effectively.

In banking, not only the actual existence, but even the *potential* existence, of government contingent liability to large numbers of bank creditors (depositors) in case of bank insolvency, either through de jure or de facto deposit insurance, fundamentally changes the role of government as it relates to banking.

As a purely descriptive matter, governments in democracies respond to political pressure. For a variety of reasons, voters feel that government is responsible for maintaining and ensuring the integrity of the banking system. In other words, regardless of the nature of the regulatory regime in place in a particular jurisdiction, governments in democratic countries take responsibility for the safety and soundness of their countries' banking systems. One way that this political reality manifests itself is in the form of bank bailouts after banking crises. There have been large or systemic banking failures in many industrialized democracies, including the United States, Russia, the Czech Republic, Israel, Argentina, Japan, Sweden, Finland, Norway, the Netherlands, and France. In every one of these countries, bank failures have led, inter alia, to government bailout of most, if not all, depositors of the bank suffering financial crisis.¹⁴

The bailouts have taken one of two forms. In countries with de jure deposit insurance regimes, such as the United States (Federal Deposit Insurance Corporation Act of 1933), the nature and limits of the government's exposure are set ex ante—that is, before a banking crisis has manifested itself.¹⁵ In other democracies that have experienced banking crises without the existence of deposit insurance (e.g., Israel and Sweden), the absence of such insurance has been viewed ex post (after the banking crisis has manifested itself) as a regulatory failure.¹⁶ To cope with this failure, the government has acted as

14 For example, in the United States the S&L failures in the 1980s led to massive bailouts. The government bailout for just one S&L, the Lincoln Savings and Loan, cost over \$2 billion. In 1998 hundreds of Russian banks collapsed after a massive panic run by depositors; a smaller but still substantial run on Russian banks occurred in 2004. Both prompted government promises of bailouts. In Israel, the Trade Bank collapsed after an employee embezzled over \$50 million. The Israeli government bailed out all of the investors. In Japan, many large banks teetered on the edge of collapse when many of their large loans, secured by real estate and securities, essentially went into default after the bubble economy of Japan burst in the late 1980s. Many Swedish banks, in the early 1990s, were in danger of collapse and the government decided to guarantee all deposit accounts in 1992. See Urban Bäckström, Governor, Riksbank, Financial Crises: The Swedish Experience, Speech at the Trilateral Commission (Nov. 7, 1998), <http://www.riksbank.com/upload/2935/981107e.pdf>.

15 12 U.S.C. § 1822(b) (2000).

16 See BANK OF ISRAEL, ISRAEL BANKING SYSTEM—ANNUAL SURVEY 2002, available at <http://www.bankisrael.gov.il/deptdata/pikuah/skira02/skira02e.htm>; Urban Bäckström, Governor,

though it were responsible for meeting the liabilities of the failed bank. In other words, where no de jure deposit insurance regime exists, there has been a de facto deposit insurance regime, as the government has stepped in after the fact and made good on deposits and other claims.

Given this political reality, it is a mistake to compare a regulatory regime such as the one that exists in the United States with a mythical unregulated regime in which the government can credibly commit itself to stand aside, watch bank failures, and do nothing in response (an example of what Ronald Coase and Harold Demsetz have characterized as the “Nirvana” fallacy).¹⁷ In other words, the desire for political survival has led politicians and policy makers to offer bailouts even in the absence of explicit deposit insurance protection. Thus, the real-world policy choice in banking is between a regulatory regime characterized by de jure (explicit) deposit insurance protection and a “non-regulatory” regime characterized by de facto (implicit) depositor protection in the form of government bailouts of failed banks after a banking crisis has manifested itself.

Seen from this *realpolitik* perspective, deposit insurance of one of these two types is inevitable. We must choose between these two regimes rather than among either of these regimes and a mythical alternative. For a variety of reasons, I will argue that a regulatory regime of well-defined, explicit, ex ante, de jure deposit insurance is unambiguously superior to a world of undefined, implicit, ex post, de facto deposit insurance.

De facto deposit insurance regimes impose uncertainties. Since it is clear that government will be responsible for bank failures to some extent, the nature and limits of that responsibility are not transparent to investors in regimes with de facto rather than de jure deposit insurance regimes. This uncertainty leads to two types of inefficiencies.

First, creditors will demand compensation for the lack of certainty concerning the nature of the governmental guarantees in a de facto deposit insurance regime. Second, greater resources will be expended in rent-seeking by creditors faced with a crisis in the bank or banks in which they have deposits. This, in turn, will likely lead to bailouts either of all creditors of banks in democracies without de jure deposit insurance (which has been the historical norm) or else to bailouts of only the most politically powerful creditors. Neither of these alternatives is attractive from a public policy point of view because each involves the waste of real resources.

Riksbank, Financial Crises: The Swedish Experience, Speech at the Trilateral Commission (Nov. 7, 1998), <http://www.riksbank.com/upload/2935/981107e.pdf>.

17 The Nirvana fallacy refers to the tendency to identify market failures such as externalities and then to conclude reflexively that government regulation would be optimal, without considering whether the inefficiencies and other costs associated with such regulation outweigh the benefits. This problem was first suggested in Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 43 (1960), and then identified explicitly in Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1 (1969).

Thus, the advantage of de jure deposit insurance is that such insurance reduces the government's actual and contingent liability for bank failures from the totality of the banks' liabilities to the amount specified in the deposit insurance legislation. In light of the fact that all democracies lacking de jure deposit insurance but facing systemic bank failure have bailed out all creditors, this represents a significant reduction in the government's exposure. In other words, de jure deposit insurance allows government to credibly commit to a relatively low level of protection, thus capping its liability at the amount specified in the deposit insurance regime.¹⁸

In addition, de jure deposit insurance limits the economic waste associated with rent-seeking by reducing the rent-seeking by creditors seeking recourse from the government that occurs both in anticipation of, and in the wake of, bank failures. Thus, the most credible way for government to limit its exposure to a banking crisis is to constrain itself ex ante by providing a regulatory scheme of de jure deposit insurance.

Having established that government-sponsored, statutory deposit insurance programs are an efficient regulatory mechanism as compared to the alternative, ex post, ad hoc governmental responses in the wake of bank failures, the question becomes not whether regulation makes sense, but rather what sort of regulation makes the most sense. This is because deposit insurance provides a solid, irrefutable reason for government regulation. Such regulation is necessary for the same reason that monitoring and control is required in private sector insurance markets. Namely, it mitigates what economists call "moral hazard problems" (moral hazard refers to the proclivity to excessive risk-taking by insured entities in order to transfer wealth from insurers to themselves).¹⁹

A wide array of options is available to governments and private sector entities in the insurance business. These regulations will likely include contractual restrictions that apply to banks in exchange for government-sponsored deposit insurance regimes. These private-sector options include:

- Entry restrictions (limiting who qualifies for insurance)
- Guidelines on capital maintenance
- Guidelines on distributions of free cash flow
- Activities restrictions and regulations
- Regulation of management quality
- Regulation of banks' investment policy
- Regulations requiring diversification of investments

18 The Federal Deposit Insurance Corporation ("FDIC") insures individual deposit accounts up to \$100,000. See 12 C.F.R. § 330.6(a) (2005). The FDIC also has discretion to suspend a bank's deposit insurance if the FDIC determines it is taking too much risk with deposited funds. See 12 U.S.C. § 1818(a) (2000); 12 C.F.R. § 330.3(a) (2005). Further, there is almost no coinsurance in deposit insurance, so, in effect, \$100,000 is the effective limit. See MACEY ET AL., *supra* note 5, at 249.

19 MACEY ET AL., *supra* note 5, at 247-48.

- Restrictions on self-dealing
- Right to enter the premises and examine financial records and other information produced by the insured.

II. Case Study # 1: The S&L Crisis

Having discussed the demand for regulation in the banking industry, we will now turn to the critical question of how to make government regulation in this critical area function.²⁰ Here, I argue that the S&L crisis is directly attributable to deregulation that permitted banks to engage in excessive amounts of risk-taking. S&Ls were originally chartered to provide fixed term mortgages to average Americans. In turn, S&Ls were heavily regulated and limited to the long-term mortgage business. However, liberalization eventually occurred. Texas approved a major liberalization of S&L powers in 1967 that, among other things, permitted S&Ls to make loans on undeveloped property, regardless of the lack of income generated by such property, in amounts up to 50% of the appraised net worth of such undeveloped properties. Then the Financial Institutions Regulatory and Interest Rate Control Act of 1978 allowed S&Ls to invest up to 5% of their total assets in each of the following types of loans: development, construction, and education loans.²¹ This meant that all of an S&L's equity would be at risk, not from fluctuations in the relatively stable home mortgage market, but from fluctuations in the notoriously volatile real estate development and construction markets.²²

From 1980 to 1982, the pace of deregulation quickened. Statutory and regulatory changes gave the S&L industry new powers that permitted them to enter new areas of business to promote greater profitability. For the first time in history, the government approved measures aimed at improving S&L profitability rather than at promoting the traditional, fiscally conservative goals of broader access to housing and home ownership.²³

In March 1980 the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) was enacted.²⁴ The statute, promulgated during the Carter Administration, removed interest rate ceilings on deposit accounts and expanded the ability of federally chartered S&Ls to make loans for corporate

20 For an excellent earlier treatment of the same subject in this context, see MARTIN A. LEVIN & MARY BRYNA SANGER, *MAKING GOVERNMENT WORK: HOW ENTREPRENEURIAL EXECUTIVES TURN BRIGHT IDEAS INTO REAL RESULTS* (1994).

21 12 U.S.C. § 3401 (2000).

22 This history draws heavily on the Federal Deposit Insurance Corporation's monograph, *Federal Deposit Insurance Corporation*, *supra* note 10. See generally LOWY, *supra* note 2; MARTIN MAYER, *THE GREATEST-EVER BANK ROBBERY: THE COLLAPSE OF THE SAVINGS AND LOAN INDUSTRY* (1990); STEPHEN PIZZO ET AL., *INSIDE JOB: THE LOOTING OF AMERICA'S SAVINGS AND LOANS* (1989); NORMAN STRUNK & FRED CASE, *WHERE DEREGULATION WENT WRONG: A LOOK AT THE CAUSES BEHIND SAVINGS AND LOAN FAILURES IN THE 1980s* (1988).

23 See Edward L. Rubin, *Communing with Disaster: What We Can Learn from Jusen and the Savings and Loan Crises*, 29 LAW & POL'Y INT'L BUS. 79, 84 (1997).

24 12 U.S.C. § 226 (2000).

acquisitions, commercial development, and construction projects. Finally, DIDMCA raised the ceiling on government deposit insurance from \$40,000 to \$100,000 without adding any additional restraints or regulation, such as promulgating regulations that link insurance premiums to risk in order to diminish moral hazard.²⁵

In November 1980, the Federal Home Loan Bank Board (FHLBB) reduced the minimum capital requirements for federally insured S&Ls from 5% of total deposits to 4% of total deposits. Also that month, the FHLBB reduced curbs on risk-taking by removing regulatory limits on the amount of brokered deposits ("hot money") that S&Ls could hold.²⁶

These reforms were followed in August by the Tax Reform Act of 1981,²⁷ which provided powerful tax incentives for real estate investment by individuals, helping to create a strong demand for real estate loans and leading to extensive over-building.

In September 1981 the FHLBB permitted troubled S&Ls to meet their recently reduced minimum capital requirements by issuing so-called "income capital certificates" that were included as equity capital on S&L balance sheets. The effect of these certificates was to make insolvent financial institutions appear solvent for regulatory accounting purposes. These certificates did not comply with Generally Accepted Accounting Principles (GAAP), either for banks or for any other type of business. Such certificates, if issued by private firms, would have constituted securities fraud.²⁸

These deregulatory efforts were followed during the period from 1982 to 1985 by significant reductions in the FHLBB regulatory and supervisory staffs at a time when the industry was growing by leaps and bounds. In that period of staff reductions, S&L industry assets (loans) increased by 56%. Forty Texas S&Ls tripled in size, and many S&Ls in California and Texas grew at rates in excess of 100% per year.²⁹

Like much of S&L "deregulation" of the era, these changes are better described as "de-marketization" or "dis-incentivization" because of the perverse incentives they created. For example, in January 1982, the FHLBB reduced net worth requirements for insured S&Ls from 4% to 3% of total deposits. S&Ls were allowed to depart from GAAP still further through the

²⁵ NED EICHLER, *THE THRIFT DEBACLE* 64-65 (1989); WHITE, *supra* note 2, at 72-74.

²⁶ See Federal Deposit Insurance Corporation, *The S&L Crisis: A Chrono-Bibliography*, <http://www.fdic.gov/bank/historical/S&L>. The term "brokered deposits" refers to blocks of funds pooled by securities broker-dealers and then placed in depository institutions offering the highest (federally insured) yield. During the thrift crisis of the 1980s, many failing institutions used brokered deposits to "gamble on resurrection." As a result, supervisors now closely monitor institutions that rely heavily on this type of funding. See Fed. Reserve Bank of St. Louis, *Community Banks Tap into "Cedars" To Grow* *Deposits*, CENT. BANKER, Summer 2003, http://www.stlouisfed.org/publications/cb/2003/d/pages/cedars_deposits.html.

²⁷ Tax Reform Act of 1981, Pub. L. No. 96-221, 94 Stat. 132.

²⁸ Rubin, *supra* note 23, at 86.

²⁹ See *supra* note 26.

introduction of “Regulatory Accounting Principles” (RAP) which only applied to S&Ls, were inconsistent with GAAP, and permitted banks to artificially pad their balance sheets, claiming that they had far more capital than they in fact had.³⁰ As one congressman observed, RAP

is a set of rules invented during the Reagan administration as one of the kingpin codes of deregulation. . . . This new set of accounting principles was really an invitation to fiscal conspiracy, a tool for deception and fraud, a vehicle for the perpetuation of elite stealing. RAP guaranteed the monumental expansion of phony bookkeeping. RAP made the present savings and loan debacle inevitable.

The S&L RAP is an amazing creation. In summary, it was an admission that the books (of federally insured S&Ls) could not be balanced and time-honored standards could not be met. The bureaucratic solution was to redefine the meaning of balanced books and set the standards lower. Instead of solving the problem a decision was made to hide the problem in a grand embrace.

A transfusion of new official jargon gave new life to the network of racketeering enterprises that infested the country. The day of reckoning was delayed with a device offered by that same government which would later have to pay the bill. More time was granted for new schemes and conspiracies. New opportunities were provided for the massive siphoning operations to be executed. The great swindlers knew that the day of reckoning was coming but RAP gave them a new extension.³¹

In April 1982 the FHLBB issued new regulations that made it much easier for risk-taking speculators to purchase S&Ls. These new regulations eliminated restrictions on the minimum number of S&L shareholders. Previous regulations required that each S&L have at least 400 stockholders, at least 125 of whom were from the “local community.” Also, no individual could own more than 10% of the stock of an S&L, and no “controlling group” could own more than 25% of an S&L’s stock. The new regulations permitted single owners for S&Ls, thus reducing market monitoring and creating incentives for excessive loan concentrations among borrowers. In particular, these regulations made it easier for individuals to buy S&Ls by allowing them to put up land and other hard-to-value real estate assets, as opposed to cash, when purchasing ownership interests in a thrift institution.³²

It was in late 1982, however, that the real race to the bottom began among regulators. In December Congress passed the Garn-St. Germain Depository Institutions Act of 1982.³³ This Reagan Administration initiative was designed to give even broader powers to federally chartered S&Ls with a view to making them more profitable, as well as more diversified. The major provisions of the statute included eliminating the ceilings on interest rates paid on deposits,

30 EICHLER, *supra* note 25, at 79-80; EDWARD J. KANE, THE S&L INSURANCE MESS: HOW DID IT HAPPEN? 10-22 (1989); WHITE, *supra* note 2, at 82-87, 112-13.

31 136 CONG. REC. 18,588 (daily ed. July 20, 1990) (statement of Rep. Owens).

32 EICHLER, *supra* note 25, at 90-100; WHITE, *supra* note 2, at 106-11; Gregory A. Lilly, *The Savings and Loan Debacle: Moral Hazard or Market Disaster?*, in THE CAUSES AND COSTS OF DEPOSITORY INSTITUTION FAILURES 119 (Allin F. Cottrell et al. eds., 1995).

33 Garn-St Germain Depository Institutions Act, Pub. L. No. 97-320, 96 Stat. 1469 (1982).

eliminating the previous statutory restrictions on loan-to-value ratios, and expanding the powers of federal S&Ls to invest in assets unrelated to the business of making home mortgages. Those S&Ls with federal charters were now permitted to put up to 40% of their assets in commercial mortgages, up to 30% of their assets in consumer loans, up to 10% of their assets in commercial loans, and up to 10% in commercial leases.³⁴

The Garn-St. Germain Depository Institutions Act caused immediate, massive defections of state chartered banks to the federal system so that bank equity holders could avail themselves of the expanded powers permitted under the Act. Soon thereafter, California, followed closely by Texas and Florida, passed a law permitting state-chartered (but federally insured) S&Ls to invest 100% of deposits in any sort of venture whatsoever. Within a year, 10% of all S&Ls were insolvent as measured by standards consistent with GAAP. These S&Ls were permitted to remain open because they were not insolvent when the artificial equity permitted under RAP was included in their balance sheets, and they retained their ability to attract additional liquidity to meet current financial obligations, because the liquidity came in the form of federally insured deposits, which they could attract by offering slightly higher rates of interest or other inducements (toaster ovens, televisions, etc.) to depositors.³⁵

Thirty-five percent of all S&Ls were losing money by 1983. Such a result, along with the high rate of bank failures reported in the previous paragraph (10%), is consistent with the conclusion that banks were taking advantage of their new powers by engaging in excessive risk-taking of the “heads I win, tails the taxpayer loses” variety. Shareholders, as equity claimants, benefited from the higher returns garnered when excessive risks paid off. The government, and ultimately taxpayers, bore the brunt of the burden when the heavily leveraged banks became insolvent.³⁶

To understand this basic application of financial theory, imagine a bank that is barely solvent. The bank has \$100 million in assets and \$99.9 million in liabilities, leaving it with \$100,000 in equity.³⁷ Suppose the bank shifts its assets from relatively safe home mortgages to a high risk investment in real estate with payoff characteristics such that there is a 0.5 probability that the bank will lose one-half of its assets (\$50 million) and a 0.5 probability that the bank will garner a return of 50%, resulting in a gain of \$50 million.

If the first, negative result materializes, the shareholders will have lost only their equity, \$100,000. The depositors or, more accurately, the government-sponsored deposit insurance fund (together with the uninsured

34 *Id.* See also *supra* note 26.

35 See EICHLER, *supra* note 25, at 79-80; KANE, *supra* note 30, at 10-22; WHITE, *supra* note 2, at 82-87, 112-13.

36 See KANE, *supra* note 30, at 63-70; Rebel A. Cole et al., *Deregulation Gone Awry: Moral Hazard in the Savings and Loan Industry*, in THE CAUSES AND COSTS OF DEPOSITORY INSTITUTION FAILURES, *supra* note 32, at 29; Rubin, *supra* note 23, at 85.

37 This follows from the basic balance sheet equation (assets – liabilities = equity).

depositors, if any) will have lost the balance of \$49.9 million. Alternatively, if the second, positive result materializes, the shareholders will have gained \$50 million, and the government-sponsored deposit insurance fund and uninsured depositors will have gained nothing. More generally, this investment has an expected payoff to shareholders of $\$24,950,000 [0.5(-\$100,000) + 0.5(\$50,000,000)]$. Holding expected returns (the sum of the possible outcomes, after each possible outcome is multiplied by its respective probability) constant, the riskier the venture (as measured by the standard deviation of expected outcomes), the more valuable the venture is, *ex ante*, to equity investors.

The deregulatory process just described had a profound effect on the risk-taking proclivities of S&L owners. Once the regulatory constraints were removed since government-sponsored deposit insurance was still available at low, fixed cost (i.e., not adjusted for risk), acute moral hazard emerged in the form of providing extremely strong perverse incentives for S&L shareholder-owners to engage in excessive risk-taking. The consequences of this for U.S. taxpayers were significant. Fixed claimants had no incentives to monitor banks' excessive risk-taking because deposit insurance insulated them from the consequences of such risk-taking.

Without government regulation to substitute for the market discipline typically supplied by contractual fixed claimants, disaster ensued. In other words, supporters of deregulation of the S&L industry failed to perceive that government regulation in an environment of insured depository institutions is necessary for the stability of the financial system. Such government regulation serves as a necessary substitute for the restrictions that private sector creditors would place on risk-taking by borrowers.³⁸

It has been suggested that the debacle of the S&L de-marketization resulted "not so much from poor policy choices as from flawed management of the deregulation process."³⁹ Further, there is some evidence that the deregulatory policies were a legitimate, though failed, response to the troubled condition of S&Ls in the late 1970s. S&Ls were initially chartered to provide long-term mortgages, at sub-market interest rates, to the average American homeowner. But with the soaring interest rates of the late 1970s and early 1980s, the cost of providing long-term mortgages proved economically unsustainable. In short, S&Ls found it hard to stay profitable. During the 1980s the federal government responded by allowing S&Ls to enter into new investment areas such as acquisition, development, and construction loans

38 See WHITE, *supra* note 2, at 75-81. For a detailed discussion of the sorts of contractual devices that constitute the market discipline typically supplied by contractual fixed claimants, see Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

39 See LEVIN & SANGER, *supra* note 20, at 42.

without much limit. It was hoped that this would make the S&Ls profitable, although what was missing was concomitant oversight.⁴⁰

It is certainly true that loosening government constraints on banks required more rather than less regulatory oversight. However, it is a mistake to conclude that the disastrous de-marketization of the S&L regulation was a consequence merely of poor policy choices or of a failed ideology. The better explanation is rent-seeking. These “deregulatory” policies, which enriched equity owners of S&Ls, resulted from a desire to garner political support from politically powerful bankers, particularly in the key election states of California, Florida, and Texas. For example, in April 1987, shortly before he was forced to resign as chair of the FHLBB, Edwin Gray was summoned to the office of Senator Dennis DeConcini, who along with four other senators (John McCain, Alan Cranston, John Glenn, and Donald Riegle) questioned Gray about the appropriateness of FHLBB investigations into Charles Keating’s Lincoln Savings and Loan. All five senators, who later came to be known as the “Keating Five” received campaign contributions from Keating. The subsequent failure of Lincoln Savings and Loan was estimated to have cost the government over \$2 billion.⁴¹

This case study shows that rent-seeking and other forms of abuse of the government decision-making process manifest themselves in the form of “deregulation” as readily as in the form of regulation.⁴² This is a straightforward application of the insight that the power to deregulate, like the power to regulate,⁴³ and the power to refrain from regulating,⁴⁴ are tempting

40 See DAVID L. MASON, FROM BUILDINGS AND LOANS TO BAIL-OUTS: A HISTORY OF THE AMERICAN SAVINGS AND LOAN INDUSTRY, 1831-1995, at 213-17 (2004); NAT’L COMM’N ON FIN. INST. REFORM, RECOVERY & ENFORCEMENT, ORIGINS AND CAUSES OF THE S&L DEBACLE: A BLUEPRINT FOR REFORM 1-5, 29-61 (1993).

41 See Federal Deposit Insurance Corporation, *supra* note 10.

42 See *supra* note 1 for the point that deregulation generally is incomplete, and therefore cannot accurately be viewed as removing government involvement from the realm of private ordering. The quotation marks around the term “deregulation” are meant to denote this fact.

43 The notion of using regulation to benefit private parties rather than to serve the public interest was first developed formally by the University of Chicago’s George Stigler, who modeled the regulatory process as a function of the government’s ability to benefit private parties by restricting entry into markets, policing cartels, and legitimizing various price-fixing strategies. These devices, Stigler showed, make it possible for private firms, able to galvanize into effective political coalitions, to earn super-competitive returns called economic rents. In a nutshell, Stigler showed how regulation can benefit the regulated, rather than the public. According to Stigler, the market for regulation consisted of providing value to politicians in the form of campaign contributions, efforts to organize voting, intimations of future jobs, and occasional outright bribes in return for favorable regulation. Major research advancing the “rent-seeking” (also known as the “public choice”) approach to regulation has been contributed by James Buchanan, Sam Peltzman, Robert Tollison and Gordon Tullock. Consistent with one of the principal insights of this school of thought, this Article models politicians, bureaucrats, and others involved in the policy-making process as rational economic actors who, subject to a variety of constraints, act in their own self-interest, rather than some vaguely defined conception of the public interest. See GEORGE STIGLER, THE CITIZEN AND THE STATE: ESSAYS ON REGULATION (1975).

44 See generally FRED S. MCCLESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION (1997).

sources of rent for governmental actors and thereby provide valuable rent-seeking opportunities for interest groups.

Students of public policy and others interested in improving the quality of regulation and policy formation should understand the incentive structure under which policy-makers and regulators operate. As was shown in the case of the S&L crisis, the failure to understand this incentive structure makes it easier for powerful interests to unshackle themselves from reasonable restraints on excessive risk-taking under the ideological guise of “deregulation.”

III. Case Study # 2: Lender Liability and Environmental Protection

Lender liability refers to civil liability for money damages and other relief that may be imposed on banks and other lenders that cause damages or act in bad faith, either to borrowers or to third parties outside of the debtor-creditor relationship. For example, when a lender makes explicit or implicit promises to extend credit and then imposes harm on a client by reneging on the promise, the lender is likely to be liable to the client. Similarly, when a particular lender takes actions that impose harm on a third party, such as another creditor, by improperly diverting assets of the debtors to itself, the third party can bring a lawsuit against the lender. So, for example, where a bank has loaned a client money, and uses its influence over and/or access to the client’s transaction accounts to benefit itself at the expense of other, similarly situated or senior creditors, these creditors can seek civil remedies against the bank for damages.

An area of intense uncertainty in lender liability that involves very high stakes is the area of lender liability for environmental damage on a debtor’s property. The problem begins with the so-called Superfund statute, also known as the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).⁴⁵

CERCLA imposes cleanup costs on “owners” or “operators” of hazardous waste sites without regard to fault. The problem is that, as often happens when a borrower becomes financially distressed, large bank lenders, who often have a security interest in all of the borrower’s assets, will actually take over the day-to-day operation of the debtor’s plant when the borrower defaults. Where there is hazardous waste on the site, if the bank is deemed to have become an “operator” of the facility within the meaning of CERCLA, then it will be strictly liable for the costs of cleaning up the facility, regardless of when the damage occurred.

To protect banks and other secured lenders from the broad liability of CERCLA, the statute contains a specific exemption for a person who “without participating in the management of a vessel or facility, holds indicia of

⁴⁵ Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601-9657 (2000).

ownership primarily to protect his security interest in the vessel or facility.”⁴⁶ However, the contours of the statutory exemption for secured lenders are a bit vague, since what it means to participate in management, or to hold indicia of ownership “primarily to protect” one’s security interest, is open to interpretation. Of course, there is no problem as long as the borrower is making timely payments of principal and interest. Once a borrower defaults, however, and the lender takes possession of the collateral, it is difficult to avoid the argument that the bank is participating in management if the collateral is the entire facility.

The potential for CERCLA to impose millions of dollars in liability on banks, despite the statute’s exempting language, manifested itself in the early 1990s when judges began interpreting the meaning of the “operator” language in CERCLA. In particular, in *United States v. Fleet Factors Corp.*,⁴⁷ the court held that

a secured creditor may incur [strict liability for the costs of an environmental cleanup under CERCLA] by participating in the financial management of a facility to a degree indicating a [mere] *capacity to influence* the corporation’s treatment of hazardous wastes. It is not necessary for the secured creditor actually to involve itself in the day-to-day operations in order to be liable—although such conduct will certainly lead to the loss of the protection of the statutory exemption. Nor is it necessary for the secured creditor to participate in management decisions relating to hazardous waste. Rather, a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose.⁴⁸

This opinion sent shocks through the financial community as banks and other secured lenders fretted that they would have to choose between the unattractive alternative of relinquishing their ability to take possession of their collateral in case of default and the even worse alternative of taking action that might lead to potentially devastating claims for clean up costs under CERCLA.

In the wake of the decision in *Fleet Factors*, lawyers for secured lenders began advising their clients about how to avoid liability under CERCLA if their borrowers should default. Lawyers began advising their clients to stop such common and socially desirable activities as monitoring facility operations and compliance with legal requirements of federal and local environmental codes and providing strategic and financial advice to borrowers in distress—all because lawyers were concerned that such activities would make the lenders strictly liable as operators of a facility because they had “participated in management,” either generally or with regard to environmental issues.⁴⁹

46 42 U.S.C. § 9601(20)(A) (2000).

47 901 F.2d 1550 (11th Cir. 1990), *cert. denied*, 498 U.S. 1046 (1991).

48 *Id.* at 1557 (emphasis added).

49 See MACEY ET AL., *supra* note 5, at 228.

For example, prior to the misguided decision in *Fleet Factors*, lawyers commonly inspected the property of prospective borrowers for environmental problems and demanded correction of these problems before making a loan. Secured lenders also protected their investments in the borrower by requiring periodic reports from borrowers on compliance with applicable environmental regulations and by making periodic environmental inspections of the borrower's facilities to make sure that the reports were accurate. In the wake of *Fleet Factors*, lawyers began advising clients that these sorts of activities by lenders, however socially desirable, could lead to strict liability for environmental claims under CERCLA.⁵⁰

Because of the language in *Fleet Factors* that environmental liability could result where there was a "capacity to influence" the treatment of hazardous wastes, well-advised lenders were reluctant to condition the extension of credit on promises by the borrower to maintain environmental safeguards.

Environmental activists and professionals at the EPA naturally wanted to restore lenders' incentives to proactively manage environmental risk. In response, the EPA promulgated a detailed new rule, clarifying lender liability under CERCLA.⁵¹

The new rule overruled the Eleventh Circuit decision in *Fleet Factors* by making it clear that the "mere capacity to influence or the ability to influence, or the unexercised right to control" does not constitute control so as to trigger liability under the strict liability provisions of CERCLA. Also, to encourage monitoring, the rule provides that liability will not result where lenders impose contractual or other documentary requirements on borrowers to maintain certain environmental standards. Similarly, no liability will result where lenders require, as a condition for a loan, that the borrower make representations, warranties, covenants, or other promises to maintain environmental quality.⁵²

Under *Fleet Factors*, these sorts of activities might be construed as opening banks to liability for having participated in management by having the "capacity" to affect hazardous waste disposal decisions if they so choose. The EPA regulation modifying the result in *Fleet Factors* is a clear example of "marketization" by a regulatory agency. The outcome in *Fleet Factors* had the unintended consequence of removing the incentives of an important class of market participants, banks, to engage in the socially desirable activity of monitoring and controlling their borrowers' disposal of hazardous waste. By crafting a clear rule that provided protection from CERCLA liability for banks that made sure that their clients complied with the environmental laws, the

50 *Id.* at 228-32.

51 National Oil and Hazardous Substances Pollution Contingency Plan: Lender Liability Under CERCLA, 40 C.F.R. §§ 300.1100, 300.1105 (2005).

52 See MACEY ET AL., *supra* note 5, at 228-32.

EPA, by regulation, corrected a market distortion caused by a poorly reasoned judicial decision.

The EPA rule followed extensive consultation with banks, environmental groups and other affected parties. While the EPA rule may have reflected political pressure by banking interests, this cynical explanation of the rule is unconvincing. For one thing, banks are not repeat player constituents of the EPA and are therefore not likely to be interested in spending the resources necessary to “capture” the Agency, even if they could. Moreover, environmental groups, who are, of course, repeat players before the EPA, also favored amending the rule because they, like the banks, favored creating a “safe harbor” from CERCLA liability for bank monitoring of environmental hazards. Finally, firms themselves were not adverse to this rule, because the potential liability imposed by the Eleventh Circuit decision in *Fleet Factors* raised the cost of capital and made banks unwilling to lend at a competitive rate to financially precarious firms with potential environmental issues that needed close monitoring.⁵³ Thus, in this example, the political support maximizing solution for the regulators at the EPA was also the efficient and socially optimal solution.

IV. Case Study # 3: Marketization and Federal-State Relations in Banking

The U.S. banking system operates under a system of dual state and federal chartering and safety and soundness regulation. The “dual banking system” has long enjoyed significant political support. This system ostensibly allows banks operating in any state to choose between two different sets of primary laws to define their powers and regulate their activities and investments. Banks may opt for a national charter, and be regulated by the Comptroller of the Currency, or they may pursue a state charter, in which case their primary regulator will be the banking regulator of the chartering state. It once was thought that the so-called dual banking system created good incentives for regulators, resulting in the maximum freedom from regulation possible while still maintaining a safe banking system.⁵⁴

53 The history of this controversy subsequent to the implementation of the EPA rule is fascinating. After the EPA issued its rule, the U.S. Court of Appeals for the District of Columbia Circuit rejected the rule on the Constitutional ground that it was beyond the EPA’s statutory authority to implement a rule construing the statutory provisions of CERCLA. This created tension between the executive branch and the judicial branch, as both the EPA and the Department of Justice publicly announced that they would follow the EPA rule anyway as a matter of their own administrative discretion to pick and choose cases for enforcement action. This controversy was resolved when Congress, as part of a Defense Department Appropriations measure, reincarnated the EPA’s rule and forbade further judicial review, finally making it clear that the EPA rule is the authoritative interpretation of the statutory secured lender exception to CERCLA. See National Oil and Hazardous Substances Pollution Contingency Plan: Lender Liability Under CERCLA, 57 Fed. Reg. 18,344 (Apr. 29, 1992).

54 See, e.g., GEORGE J. BENSTON ET AL., PERSPECTIVES ON SAFE AND SOUND BANKING 276-78 (1986); Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1 (1977).

“The ‘dual banking system’ has long been a sacred cow in the American political tradition.”⁵⁵ A primary “justification for the dual banking system is that it causes state and federal regulators to compete for bank charters in order to retain market share.”⁵⁶ This competition is said to lead to a diminution in the arbitrary or abusive use of regulatory discretion. Detractors of the dual banking system argue that the system leads to a destructive “race to the bottom” among regulators who compete to attract chartering business from banks.

Neither of these arguments gives proper credit or respect to the reality of post-Roosevelt Era constitutional interpretation. The federal government can—and does—invoke the Commerce and Supremacy Clauses of the U.S. Constitution to preempt state laws whenever state laws give state-chartered banks a meaningful advantage over federal banks. And, even if that were not true, as a matter of both legal compulsion and competitive necessity, all banks must obtain deposit insurance from the federal government, and the FDIC requires that banks obtaining such insurance comply with its uniform regulations regardless of contrary provisions in the laws of individual states.⁵⁷

Here there are two related points about regulation in general and state-federal relations in particular. First, the competition between the states and the federal government in the domain of banking law and regulation is more imagined than real. State regulators have generally tried to eliminate some of the most important rules that require banks to stay on sound financial footing in order to attract more banks. Conversely, the bulk of effective banking regulation comes at the federal level. Second, the paucity of meaningful competition within the federal system is socially desirable because competition between the states and the federal government in the realm of banking regulation would not produce beneficial results. In short, a strong system of federal banking regulation produces the most efficient and socially beneficial outcomes by allowing banks to allocate capital to borrowers under a system of federally regulated deposit insurance.

A. *Reserve Requirements*

The history of reserve requirement regulations for state-chartered and federally-chartered banks provides a prime example of states’ perverse incentives to regulate their domestically chartered banks in a suboptimal way. Reserve requirements consist of bank assets that must be held in the form of vault cash or non-interest paying deposits with one of the regional Federal Reserve banks or with banks approved by the Board of Governors of the Federal Reserve System. Because banks do not generate any interest or other

⁵⁵ Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 BROOK. L. REV. 1, 1 (1987).

⁵⁶ MACEY ET AL., *supra* note 5, at 115.

⁵⁷ Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 693-701 (1988).

income on these reserves, which consist of cash-on-hand and non-interest bearing accounts at the central bank, they would prefer that reserve requirements be kept as low as possible. From a financial perspective, reserves are viewed as a tax on banks' operations. Prior to 1980 national banks and state banks that had elected to be members of the Federal Reserve System were subject to reserve requirements established by federal regulation. State-chartered banks that were not members of the Federal Reserve System were not subject to these federal regulations. To avoid reserve requirements, which cut into banks' profitability, state banks began exiting the Federal Reserve System. In response, bank regulators passed the interestingly-named Depository Institutions Deregulation and Monetary Control Act of 1980, which extended the reach of the Federal Reserve requirements to state non-member banks.⁵⁸

This federal statute eliminated a major dimension of the competition within the dual banking system. The decision by Congress to impose standardized minimum reserve requirements was clearly inconsistent with the idea of competition in the dual banking system.⁵⁹ The harder question is the normative one: whether competition between state and federal chartering agencies and regulators is beneficial in banking. The problem, as the reserve requirement controversy illustrates so aptly, is that the states have no *incentive* to enact laws that constrain banks' proclivities towards excessive risk-taking.

To the extent that lax state laws permit banks to engage in excessive risk-taking, the benefits from such risk-taking fall on certain local borrowers (who would be unable to obtain credit under a more prudent regulatory regime) and often local shareholders (only a small percentage of banks are publicly held), who, as residual claimants, benefit if the risks pay off. By contrast, the costs of such risk-taking are borne not by private sector creditors of the state-chartered banks, and not by the banks' state regulators, but rather by the federal government (and depositors and taxpayers in all fifty states), who bear the costs of administering and funding the federal deposit insurance funds.

In other words, the costs of lax state regulation are borne at the federal level, and the benefits accrue at the state level, where banks lend money. Since the allocation of regulatory authority should track the incentives associated with regulating prudently, the dual banking system is a very bad policy idea in a regulatory regime, like the U.S., that is characterized by federal deposit insurance. Thus, it is no surprise that in 1991 Congress passed a statute, the Federal Deposit Insurance Corporation Improvement Act (FDICIA), that provided, *inter alia*, that no state bank insured by the FDIC could engage in any type of activity that is not permissible for a national bank, unless a federal

58 Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132.

59 Butler & Macey, *supra* note 57, at 695.

agency determines that the activity would pose no significant risk to the deposit insurance fund and the state bank complies with applicable capital standards.⁶⁰

This legislation strengthens the argument, originally set forth in *The Myth of Competition in the Dual Banking System*, that the dual banking system is, and should be, a myth.⁶¹ More importantly, the interplay between the states and the federal government provides another example of both “illusory deregulation” and the related phenomenon, incentive-enhancing regulation that either encourages, or replaces, market-driven responses to public policy problems.

With respect to the first point about illusory deregulation, clearly the elimination or reduction of reserve requirements by a state banking regulator *appears* to be an effort to achieve deregulation. However, when viewed against the background existence of federally sponsored deposit insurance, the reality emerges. Such deregulation is simply an effort by local regulators to export the costs of tolerating excessive risk-taking by bankers nationally. This enables the local regulators to enjoy greater political support from bankers, while exporting the costs of their “deregulation” onto the general population. Such actions are not deregulation. They simply reflect bad, perhaps even corrupt, public policy choices. In other words, it might be more helpful to talk about regulation that preserves incentives, and to contrast that with regulation that destroys incentives. State reserve requirement “deregulation” was really incentive-destroying regulation. Pre-emption and re-regulation by Congress restored the proper incentive structure for banks, because it reduced banks’ proclivities to succumb to excessive risk-taking.⁶²

B. *Bank Closure Policy*

Bank failure is the event against which the entire administrative scheme of regulation and enforcement in the banking industry is targeted. Bank failure is a concern as a matter of public policy, in ways that the failure of other business is not, for several reasons. First, and most obviously, the failure of an FDIC insured depository institution places the assets of the government’s insurance fund at risk. In addition, bank failures impose losses, anxiety, and inconvenience on depositors. Finally, the failure of one bank may spread to others, creating the danger of generalized banking panics.⁶³

One of the more startling historical attributes of the dual banking system is that the power to cause the appointment of a receiver for a financially distressed bank—i.e., the power to close a bank—was vested in the bank’s chartering agency. Thus, the Comptroller of the Currency has the power to

60 12 U.S.C. § 1831a (2000).

61 Butler & Macey, *supra* note 57.

62 *Id.* at 712-13.

63 See MACEY ET AL., *supra* note 5, at 723.

close national banks and, at least until 1991, state banking agencies had the exclusive power to close state-chartered banks, including federally insured banks and thrift institutions. The problem with this allocation of regulatory power was that state banking regulators had no incentive to close failed state-chartered banks, as long as those banks continued to employ people and make loans to local borrowers. Bank closures are also problematic because they lead to rashes of foreclosures of delinquent loans by the receiver of the failed banks and other events such as strict adherence to debt covenants, which, from a macroeconomic perspective, are highly deflationary to local economies.

Thus, as with reserve requirements, recalcitrant state bank regulators, particularly in Arizona, California, Florida, and Texas, were able to transfer wealth to themselves from the federal deposit insurance fund as administrative delay increased the ultimate costs of resolving failures of state-chartered banks. As the costs of bailing out the insurance funds soared in the 1980s, and the issue of bank failure became politically salient, Congress finally, in the FDICIA, gave the FDIC the power to close state-chartered insured banks in cases in which such closure is necessary to avoid or mitigate losses to the insurance fund.⁶⁴

While FDICIA clearly represents encroachment by federal regulators onto turf long occupied by state regulators, it also is consistent with market principles and economic theory, because it allocates regulatory responsibility over bank closure to the regulator with the greatest stake in implementing optimal closure policy. Thus, the provisions of FDICIA wresting regulatory authority over the timing of bank closures away from state regulators are an example of market-based, incentive-compatible regulation.

C. *Minimum Capital Requirements*

While the term “capital” is used in a variety of different contexts in banking and finance, for the purposes of this Article, capital refers to the amount by which a business’s assets exceed its liabilities. The terms “equity” and “net worth” also are used to describe this differential. For most businesses, the amount of capital that a firm has is regulated entirely by market forces, as it should be in a free market economy. Firms that want to borrow money must have a certain amount of equity as a cushion for the lenders, in case the value of the firms’ assets unexpectedly declines. Similarly, lenders often will impose various restrictions on the type and amount of subsequent borrowing that their clients will be permitted to do. Borrowers who do not want this sort of market-based restriction on their capital structure must refrain from borrowing, or pay higher rates of interest to compensate lenders for their perceived risk.

⁶⁴ Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236.

In theory, at least, if a bank has enough capital, its creditors will never suffer losses. This is because as long as a bank's assets can be sold for more than the amount of their liabilities (plus the administrative costs associated with the asset sale, and subsequent distribution of cash), the institution's creditors will be repaid in full. One of the problems observed in the discussion of bank closure policy in the previous section was that state regulators who kept state-chartered banks open after they were actually insolvent increased the ultimate size of the losses shouldered by the federal deposit insurance agencies. During this period, the quality of banks' assets eroded, and bank shareholders engaged in desperate and risky attempts to return the bank to solvency.

The regulatory issues associated with minimum capital requirements are nicely summarized in a U.S. Treasury report:

In a private, competitive market economy, the primary purpose of capital is to cushion both equity holders and debtholders from unexpected losses. Debtholders are protected by the "equity cushion" that must be exhausted before the firm's losses eat into their principal. Equity holders are protected in the sense that, in a world where bankruptcy is costly, substantial equity reduces the probability that bankruptcy will occur.

The existence of the federal safety net for depository institutions [notably federal deposit insurance and access to the Federal Reserve discount window] increases the importance of capital, since the safety net adds taxpayers to private debtholders as potential losers if an institution fails. Adequate capital holdings by depository institutions therefore have the following positive benefits: (1) lowers the probability of bank failure; (2) reduces the incentive to take excessive risk; (3) acts as a buffer in front of the insurance fund and the taxpayer; (4) reduces the misallocation of credit caused by the safety net subsidy [e.g. the tendency for such a subsidy to foster the growth of weak banks relative to non-banks and healthy banks]; (5) helps avoid "credit crunches"; and (6) increases long-term competitiveness.⁶⁵

Stunningly, there was a time when state regulators could set minimum capital requirements for state-chartered banks. As with bank closure policy and reserve requirements, this rule led to several problems, as state regulators, in a regulatory world of federal deposit insurance, lacked the proper incentives to establish capital requirements for state-chartered banks that provided adequate protection for the federal deposit insurance fund. Federal regulators have more appropriate incentives because the cost of insufficient capitalization for banks is borne at the federal level. By contrast, state regulators, by relaxing the levels of capital that banks are permitted to hold, can conduct homegrown macroeconomic policy by encouraging localized lending and over-leveraging. In doing so, the local regulators can, under the guise of "deregulation," transfer wealth to local banks from the federal government and its deposit insurance fund.

⁶⁵ U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS II, at 1 (1991).

D. *Banking and Beneficial Regulation*

The three issues studied in Part IV—reserve requirements, bank closure policy, and minimum capital requirements—all represent situations in which the states, under the guise of “deregulation,” inject market distortions into the regulatory system by relaxing rules that contribute to bank safety and soundness, which is a national issue. The existence of federal deposit insurance strongly suggests that bank safety and soundness regulation should be dealt with at the national level. The debacle of the S&L crisis and the related insolvency of the Federal Savings and Loan Insurance Corporation were due in large part to the misallocation of regulatory responsibilities between the states and the federal government. The problem was not deregulation in these cases; rather, the problem was insufficient regulation. When the situation was corrected, the new regulations were market-mimicking in the sense that they replicated the rules that private insurance markets would have imposed if the federal deposit insurance scheme were to be privatized.

The broader theme of this Article is that regulation at the appropriate level is often necessary to cause the market to function effectively. Banks are very efficient at allocating capital, but they are very fragile economic entities. One example of beneficial banking regulation is the EPA clarification of lender liability after *Fleet Factors*. Before the EPA clarification, banks that demanded that borrowers comply with environmental laws were subject to liability for the borrowers’ subsequent violations. This was clearly not an efficient outcome and further regulation was needed to restore banks’ ability to lend to such borrowers.

Deposit insurance is the most salient example of beneficial government banking regulation. Without government intervention in the form of deposit insurance and access to emergency loans, banking crises of the kind observed during the Great Depression would be regular occurrences. Not only does deposit insurance prevent bank runs and panics, it can also serve the valuable end of capping the extent to which the government will be expected to respond in case of a systemic banking crisis. History has shown that, in the absence of *de jure* deposit insurance specifying the nature and extent of the government’s contingent liability to depositors in case of bank failure, the government’s exposure to creditors in case of bank failure is unbounded. Thus, banking is a paradigmatic example of an industry in which regulation is necessary for a market, indeed for an entire industry, to function efficiently.

V. Conclusion

This Article presents a new approach to the concept of “deregulation” in financial services and particularly banking. Generally, regulatory policy is thought to involve more or less binary choices between regulation and deregulation. Those especially concerned with market failure and equality of

outcomes prefer regulation, and those with faith in markets and concerns about efficient outcomes prefer deregulation. Government regulation is often necessary, sometimes in generous measure, to facilitate strong private markets. Further, policy choices about whether or not to regulate are susceptible to the same kinds of rent-seeking problems that plague decisions about how to regulate. Thus, the policymaking process affects the likely efficiency and wealth distribution effects of both regulation and deregulation.

In the case of banking, deposit insurance takes on particular economic and political significance. Deposit insurance is part of the fabric of democracy because politicians in a competitive political marketplace are held responsible for bank failures and must deal with such failures either *ex ante* or *ex post* by assuring depositors that they will be paid. Thus, in democracies, either *de jure* deposit insurance or *de facto* deposit insurance in the form of bailouts must be taken into account when evaluating any deregulation proposals. The United States has a system of *de jure* deposit insurance, which works well to avert bank runs and panics. As this Article has argued, the guiding hand of government regulation is needed in banking to avert disastrous results such as the S&L catastrophe. Banking is a prime example of how the conventional wisdom that deregulation will lead to more efficient markets is simplistic. Regulation of the banking industry is not only beneficial, but also necessary, for the market to work.

